Value Investor INSIGHT

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The Leading Authority on Value Investing

Power in Combination

Artisan Partners' Dan O'Keefe and Michael McKinnon describe the tension they see today between opportunities in the U.S. versus those in Europe, the typical kind of value-investing idea they've lost confidence in, the one Chinese stock they consider too cheap to ignore, and why they think Philips, Henry Schein, Charles Schwab and Snap-On are undervalued.

INVESTOR INSIGHT

Artisan Partners
Dan O'Keefe (*l*), Michael McKinnon (*r*)

Investment Focus: Looking for companies with the potential for long-term value growth when the magnitude or duration of that growth is undervalued by the market.

It's hard for a value investor to argue with any of the basic tenets of Dan O'Keefe's strategy, which consists of looking to own high-quality businesses with good balance sheets and capable management when their stocks are undervalued. "You're not going to hear too many people say they want to do the opposite," he says.

Defining an approach isn't the same as executing it, of course. The global value fund O'Keefe has managed or co-managed for Artisan Partners since 2007 – now with $2.5 billion in assets – has earned a net annualized 8.3%, vs. 6.5% for MSCI's All Country World Index. Today he and co-portfolio manager Michael McKinnon are finding value in such areas as medical equipment, dental-product distribution, Internet platforms, discount brokerage and tools.

From your global value investor perspective, can we ask generally how you're assessing the opportunity set at hand?

Dan O'Keefe: The only time I've ever had meaningful confidence about the general opportunity set is when everything looks terrible and valuations discount doomsday. Those are the points when I've been fairly confident equity returns were going to be excellent. The rest of the time our general predictive power is quite poor.

I would point out some interesting signposts today. The U.S. market is expensive, more so than in Europe. Some of that is justified – non-U.S. companies tend to be worse businesses, with less good management, governance and capital allocation – but even adjusted for those things valuations are more interesting outside the U.S. Technology as a sector has massively outperformed, deservedly so because it's been one of the few areas with growth, but tech stocks generally are very expensive.

When you get beyond a narrow range of mostly U.S. technology stocks, you can find good value. You can buy Chevron [CVX] in the U.S. for close to 14x forward earnings, while essentially for the same businesses economically you'll pay only around 8x for Shell [London: SHEL] or for TotalEnergies [Paris: TTE]. Something like Heidelberg Materials [Frankfurt: HEI], a global aggregates and cement manufacturer based in Germany, goes for a single-digit multiple. If it traded in the U.S. it would be at twice the multiple.

You're not alone in targeting quality businesses with good balance sheets, good management and undervalued stocks. Why is that a winning combination to you?

DO: For every investment the expected return will come from some combination of growth in per share value and, if we've done our job right, from some re-rating of the multiple. The power is in the combination of the two. If you just focus on buying statistically cheap stocks, you often end up with businesses that are shrinking or don't grow, so to earn a return you're relying almost entirely on the multiple changing. That's a hard road to go down, and I've found it's often a road to nowhere.

The better road is where you can see value per share growth from a quality business generating high returns on capital, with cash flow to deploy and good management to deploy it through capital-allocation decisions that create value. We absolutely want to pay a discount for that, but in analyzing our returns over time our best investments – like Alphabet [GOOGL] or Marsh & McLennan [MMC], both of which we've owned since 2007 – have been those where the largest source of return has been growth in earnings per share, a proxy for value per share.

You mentioned Shell, TotalEnergies and Heidelberg Materials – these don't initially sound like standout EPS growers.

DO: You don't have to be a growth company to grow value per share at an attractive rate. So yes, Shell and Total are not growth companies, but because they're returning enormous amounts of cash to us at these low valuation levels, value per share returns are strongly double-digit.

They would not be interesting absent the value creation from great capital allocation, nor would they be interesting at 13x earnings. But the combination of the capital allocation and the valuation is the magic for per-share returns.

With Heidelberg, we think the cement/aggregates business is quite attractive. Aggregates, and to a slightly lesser extent cement, are both local monopolies, resulting in significant pricing power. And importantly, there are no alternatives. Without cement, we don't have roads, buildings and cities. The business can be cyclical and isn't growing particularly fast, but the leaders in these businesses have compounded shareholder value at good rates over long periods of time.

Despite all that, the company's stock has de-rated as the economic environment in Europe has been weak and as investors there are increasingly unwilling to invest in this business because of its relatively high CO2 intensity. That's absurd to us. Without cement you don't have a civilization. Moreover, there are advancements in lowering the CO2 intensity of cement that are proving to be a profit opportunity for cement makers. Buyers will pay more for cement that has more recycled materials and is made from cleaner fuel sources. Heidelberg has made meaningful investments in lower CO2 cement and we think they will generate great returns from these investments. The stock has done well over the last two years but is still extremely cheap, trading at 8.5x consensus forward earnings. For context, Vulcan Materials and Martin Marietta Materials in the U.S. trade at more than 30x earnings.

To get a sense of what attracts your attention, what's behind your recent purchase of insurance broker Aon [AON]?

DO: We like insurance brokerage, where Marsh & McLennan and Aon are the biggest players in a global market where scale is a big advantage. Insured values rise over time. Litigation is ever increasing. Cybersecurity risk is growing. Storms are more costly due to inflation and population density. Insurance brokers benefit from these trends as they are paid fees and commissions to help clients craft the appropriate blend of insurance coverage, but they don't directly bear any of the loss risk.

We bought Aon in the second quarter. The stock had been weak because its revenue growth had underperformed Marsh, though it had still been growing at an attractive rate. The market also didn't like the recent very expensive acquisition of NFP. Aon had essentially ignored the middle market and paid up to buy NFP to address that. We love the industry and the business, though, and felt that Aon's relative revenue performance to Marsh was going to be temporary. At 16x earnings at the time of purchase, it seemed like a good risk/reward for a business which we believe can sustain double-digit earnings per share growth. I wish we had bought more. [*Note*: Around $290 at the end of June, Aon shares closed recently at $370.]

ON UNDERPERFORMERS:

It's tempting to say if they can just close the performance gap that would be great for the stock. That rarely works.

Why does something like consumer-products company Danone [Paris: BN], which has been a turnaround candidate for what some would say is an uncomfortably long time, make the grade?

Michael McKinnon: The company for many years was run by a management team and board that didn't really have shareholders' best interests in mind – I'd go so far as to say they didn't even have the company's best interests in mind. We got involved in mid-2021 around an initiative to replace the board and top management, which ended up being successful early in our ownership tenure. With newly empowered and motivated leadership in place, we continue to believe the inherent attractiveness of the company's businesses in yogurt, water and nutrition will better translate into improved operating performance. Over the past year the operating overhaul is starting to deliver results both in terms of top-line growth and improving margins. If that continues as we expect, the 12-13x normalized earnings we're paying today [at a recent price of €66] should prove to be a significant bargain.

Would you characterize your experience with auto-aftermarket business Advance Auto Parts [AAP] somewhat differently?

DO: This is an interesting, if painful, example. When we're looking at an attractive industry – which is usually what we try to do – we're naturally drawn as value investors to the underperformer. In U.S. auto parts you have a fragmented industry where the big players can use their scale advantages to continue to take share and operate with higher margins. That's evident in the performance of AutoZone [AZO] and O'Reilly Automotive [ORLY], and it's tempting to look at another scale player like Advance Auto and say if they can just close the performance gap somewhat that should be great for the stock.

What I've learned is that that very rarely works. We could call it our Advance Auto rule. I've thought about why that is and my hypothesis is that businesses that underperform for long periods rot deeply from the inside. They lose good people and knowhow. They get lax operationally. Meanwhile, the stronger competition is attracting great talent and reinvesting to go from strength to strength. You can parachute people in to try to fix the rot – Advance Auto is on its third turnaround team – but it's just very, very hard to do. I won't say it can't eventually work, but I've concluded in most cases it's just better to stay away from this kind of situation.

MM: The only thing I'd add is that while this was painful and we would have made a lot more money investing instead in AutoZone or O'Reilly, over our holding period with Advance Auto we didn't lose money. That's a testament to our wanting to buy at a minimum 25% discount to

our cash-flow-derived estimate of intrinsic value for any business. As Dan mentioned earlier that can be a source of return, but also a margin of safety in the case of error.

You focus mostly on the U.S. and Europe and your portfolio today is split pretty evenly between the two. Is that normal?

DO: The tension is usually between the quality of the businesses in the U.S. and the valuations in Europe. It's hard to shrink the U.S. below 50% of the portfolio because the companies are so good. The fact that we've got around 45% each in the U.S. and Europe reflects the valuation disparity, not that we're optimistic about the economic outlook in Europe. If we owned Chevron and Exxon instead of Total and Shell, and if we owned Pfizer instead of Novartis, our U.S. weighting would be closer to 55%.

Explain why you've never had much exposure in China.

MM: While the general investor narrative around China turned negative two or three years ago, it came more to reflect what we've thought for some time. The regulatory environment is unpredictable. Trade relationships with the West are problematic. The quality of the management teams and reporting transparency are generally below what we would consider adequate. Does that make it uninvestable, no, but the hurdle is very high.

Why is Alibaba [BABA] the one exception today?

MM: It's not our only exposure to China, but it is our only direct investment. It's also one of the cheapest stocks I've seen in my career. The way the Internet has evolved in China, the company is a combination of Amazon and Google. It's the primary way people do e-commerce, but it's also monetized heavily through what is essentially a commercial search engine. There is increasing competition in this part of the business, but Alibaba is still the dominant player in a secular-growth industry. The second big driver going forward is a cloud business, which is growing rapidly and recently became profitable. The balance sheet is overcapitalized, with a significant amount of net cash.

While all that is quite attractive, on our math not that long ago we could buy the stock at 5x unlevered earnings. After the run-up in the past couple of months that's now closer to 7-8x earnings. A lot of good things are happening here that are not recognized in the share price – the stock could double and would still be cheap.

ON GOOGLE AND AI:

For now we are comfortable that Google is much more likely to be a beneficiary of AI's advance than a victim.

We have to ask how you're processing the investing implications today of artificial intelligence.

DO: AI will influence businesses and therefore the economy across the spectrum. At one end are the direct enablers of AI, like Nvidia or TSMC, that make the chips and memory used in AI servers that run AI models. Moving out from those early beneficiaries – of which there are really very few – you have a diffuse range of companies whose businesses can potentially be enhanced through the use of AI. It could be call-center operators. Or pharmaceutical companies using the power of AI to mine data to identify promising areas for R&D. Or Meta Platforms [META] and Alphabet [GOOGL], both of which we own and we believe can enhance already extremely strong franchises through the application of AI technology.

I would also say at this point that we don't yet see what might be considered killer applications for AI that capture the imagination with extreme value-creating applications. We've got a lot of extremely expensive computing power being built out that may or may not be put to revolutionary use right away. Absent those killer use cases, what you may see is a gradual adoption of AI and returns that may not be too sexy in the near term.

Talk specifically about Google and AI.

MM: The honest answer is that we don't know how all this is going to play out, but we do believe Google has a massive advantage in AI and has been using it for years to drive growth in its business. There's now a consumer interface with Chat GPT that has gotten a lot of attention, but this is something Google is very good at and we think they're on the very short list of companies that have a right to win in this space.

Think about what you need to succeed in AI. You need the technology. You need a massive amount of very expensive computing power. You need customers using a product, like search, that would seem to be an obvious application for AI. Google has all that. Could someone come out with a great new search product? Maybe, but it will be difficult and incredibly expensive to compete with Google, which offers a free product they monetize better than almost anyone out there. Are people going to want to pay a subscription fee for AI searches? Will AI searches expand the market rather than cannibalize the existing one? We're not blind to the potential for new competition, but for now we are comfortable that Google is much more likely to be a beneficiary of AI's advance than a victim.

Describe your broader investment case today for European medical-equipment company Philips [Amsterdam: PHIA].

DO: Philips has three divisions, diagnosis and treatment, connected care, and personal health. Diagnosis and treatment accounts for about 50% of total revenue, selling primarily imaging and ultrasound equipment. Connected care is 30% of sales, consisting mostly of businesses providing patient monitoring and analytics systems as well as sleep and respiratory care equipment. The smallest segment, but

an attractive one, sells personal-care items like electric toothbrushes, electric shavers and baby bottles.

The company has been through the wringer over the past few years due to a recall in the U.S. of its CPAP [Continuous Positive Airway Pressure] machines that are used to treat sleep apnea. They had voluntarily recalled the machines when some testing showed foam used in the devices could potentially break loose and release unhealthy particles and fumes that might be inhaled. As it turns out the independent company that identified the risks made mistakes in testing that misrepresented the actual risk, but the liability suits started and there was a Food & Drug Administration inquiry. These were resolved by an FDA consent decree announced in January and by a master settlement of the litigation – without Philips having to admit wrongdoing – announced in April. We estimate the total cost from all this to be in the €3-4 billion range.

We added to our position following the settlement announcement, as attention turns to the fact that this is a leading healthcare-equipment business with solid market shares in attractive, high-margin and growing end markets. Roy Jakobs, the CEO since October 2022, is in the middle of restructuring and portfolio optimization efforts that can now get undivided focus and should result in better growth and profitability and a return of operating margins more to the 13% range, from recent levels below 10%. This won't happen until further conditions of the consent decree are met, but we also expect the sleep-apnea business to eventually come back fully in the U.S. There's incentive on many fronts for that to happen, as there is only one other company of any scale, ResMed [RMD], currently serving the market.

The company recently released earnings that disappointed the market. How are you processing that?

DO: Their China business is struggling because of the economic malaise there. Hospitals are holding back on new equipment purchases and consumers are holding back on personal health product purchases. But China is not a particularly large market for them – it's probably going to end up as a single-digit percent of revenue in 2024. While the pullback there has slowed the growth trajectory, we still expect the business to grow and margins to advance this year, just not as much as we did before.

How attractive do you consider the shares at today's price of around €24.25?

DO: The recall and litigation were overhangs on the stock, and the market doesn't yet seem willing to look at this as a normal company recovering from a difficult period but with good positions in growth markets benefitting from demographic shifts and greater healthcare access.

Assuming margins return to levels prior to the recall, we think the company can earn about €2 per share. The shares today trade at 12x that, which we consider attractive on both an absolute basis for a company with good growth prospects, and relative to peers that trade at high-teens, low-20s multiples.

You added Henry Schein [HSIC] to your portfolio in the first quarter of this year. What attracted your attention to it?

MM: The company is the world's largest distributor of dental supplies and equipment and is the second-largest distributor of medical supplies to physician offices and alternative-care sites in the U.S. It has expanded its distribution relationships to become the largest provider of practice-management software to U.S. dental offices, and provides additional related services like equipment maintenance, insurance reimbursement and financing. It has also vertically integrated into manufacturing and selling its own dental products in key growth areas like implants and endodontics. These additional products and services have better growth rates and meaningfully higher margins than the core distribution business.

The long-term trends in the dental industry are favorable, with tailwinds from an aging population, rising awareness of the importance of oral health, and increased adoption of new technology around things like digital x-rays, 3-D modeling and orthodontics. Distributors to the industry play an important role, connecting a broad range of suppliers with what tends to be a very fragmented customer base of dental offices. Schein currently distributes to more than 70% of the 200,000 or so dentists in the U.S.

The shares when we first got interested were impacted on a couple of fronts. Financial performance was normalizing after a pandemic period that saw unusually high demand for the protective equipment and COVID test kits the company supplied. They were also hit late last year by a cyberattack that proved costly and time-consuming to address. We looked through those types of temporary issues and focused more on the durable health of the distribution franchise and, importantly, on the ongoing mix shift we see toward higher-growth and higher-margin services and products.

At a recent price of around $70.50, how inexpensive do you consider the shares?

MM: We believe Schein within the next couple of years can earn $6 per share, so the stock on that basis trades at a P/E of less than 12x. This is for a business that from organic growth and the shift to higher-margin products and services – which strengthen its customer relationships and give it more control over its financial model – can increase profit overall at better than 10% per year. A high-teens multiple on that would not at all be unreasonable.

From dental products to discount brokerage, describe your interest today in Charles Schwab [SCHW].

MM: We followed Schwab for years prior to finally having the opportunity to buy it at the right price during the U.S.'s mini banking crisis in 2023, when the shares traded down to 10x what we considered normalized earnings.

We like the wealth-management business in the U.S., where a dynamic econ-

omy and natural growth in invested assets provide a nice tailwind. Schwab is an advantaged player in the business, taking share over a long period with what we consider sustainable scale advantages and a superior business model. For context, they have roughly $10 trillion in client assets, against closer to $6 trillion for Morgan Stanley or UBS.

DO: Schwab is an asset-gathering machine because it provides to investors services they value highly at a low cost, while earning disproportionate economics from things investors don't care about. Trading, custody, fund-management and advice are inexpensive or even free, so clients aggregate their assets with Schwab, a decent percentage of which is held in Schwab's own proprietary products or in cash. Those cash balances collectively are enormous and grow, on which Schwab earns a low-risk net interest margin on the float.

The low-cost structure allows them to earn high returns, which they reinvest in gathering more assets. We think their assets from continued share gains, rising wealth, and market returns can grow organically at a 10% or better annual rate.

MM: The business can be volatile depending on the performance of the stock market, trading activity and the interest-rate environment. Today we're in a lull where they're underearning. Earnings have been negatively impacted by cash-sorting by clients – mostly still within Schwab – out of cash balances paying miniscule rates to higher-yielding accounts and securities on which Schwab makes less money. At the same time, the company has had to replace money coming off its balance sheet with higher cost funding, pressuring net interest margins. Finally, there have been lingering effects on customer churn from the acquisition of TD Ameritrade in 2020.

Over the next year we expect a step up in earnings as cash-sorting impacts normalize, they use excess capital to pay down high cost funding, and the TD Ameritrade integration issues go away. We estimate earnings per share for next year at close to $5.50, more than double the 2023 level.

What upside do you see in the shares from today's $71 price?

DO: The stock trades at 13x our estimate of normal earnings, for a business that should warrant a high-teens multiple. We're more confident in the earnings growth than trying to pinpoint what the multiple should be, however. With a bad business, you need to be more precise about what the correct multiple is. That's not so much the case here – we know this can and has traded at a higher multiple, but given how confident we are in the earnings growth potential we don't have to be as precise on the exact multiple to find this attractive. But we do think a high-teens and even a low-20s multiple is possible if things really start humming again.

Why are you high on the ongoing prospects for Snap-On Inc. [SNA]?

DO: If you look at Snap-On's performance you see evidence of a powerful economic engine. The business grows consistently and with high returns on equity while maintaining a very strong balance sheet. The financials tell you there's something special going on here.

They sell very high quality own-branded tools and diagnostic equipment primarily to auto mechanics through a unique van-and-driver distribution network. The franchise-owner reps driving the vans are in close and frequent contact with their customers, who highly value the product quality and the availability and breadth of inventory the company offers. These reps take feedback and funnel it into an R&D operation focused on creating tools that solve customer problems and make customers more efficient. Brand loyalty is extremely high – we hear stories, for example, of people wanting to be buried in Snap-On branded caskets.

The industry backdrop is positive. The increasing complexity and diversity of the car park drives the need for better-quality tools and diagnostics. Auto mechanics are highly skilled and in demand, making it a good market to sell into. We also believe higher electric-vehicle adoption should be a net positive for the company. Some worry that because EVs have fewer moving parts there will be less to fix, but we think the company will benefit as repair work shifts away from engines to batteries, sensors, wiring and driver-assistance systems that will need new tools and diagnostics to service.

Snap-On's stock popped earlier this month on an unexpectedly strong earnings report. How are you looking at valuation with the shares at a recent $333?

DO: Earnings had been somewhat depressed in recent quarters, attributed to a pullback in spending by the mostly blue-collar customer base and some continued slack demand from unusually high levels during the pandemic. Those effects may or may not impact another quarter or two, but they don't in any way change our view that this business can continue to compound earnings per share at the high-single-digit to low-double-digit annual rate that it has in the past.

The stock currently trades at just under 17x consensus forward earnings. For a durable, well-capitalized, high-return business with this kind of brand and market position, that's not aggressive. It could certainly trade at a higher multiple, but given the growth in value per share we see here, as with Schwab, we don't need that to find this interesting.

Let's talk about a position or two you've sold of late and why. Nintendo?

DO: Nintendo has the hallmarks of what we'd like to own for a long time. They have the best intellectual property in a secular growth industry, but they've only tentatively monetized it across media and distribution platforms. We think they have a long runway to do that, and a Microsoft or Apple could probably pay twice the current market cap and generate a great return in accelerating that process.

The problem is Nintendo will never sell and they are unlikely to capitalize sufficiently on their IP on their own. Manage-

ment seems not to care much about shareholders or creating value through effective capital allocation. Once we concluded that wasn't going to change, we thought our capital could be better deployed elsewhere. We sold at a nice gain. But it's too bad about the governance.

Was your sale of Expedia [EXPE] somewhat in the Advance Auto category we discussed earlier?

MM: As a value investor with a long horizon we have to have patience and conviction, but also be willing to change our mind when the circumstances warrant. With Expedia the original thesis was that it operated in a growing, consolidated market with decent profitability, but its peer, Booking.com, was growing faster and had higher profitability. If Expedia got to where Booking.com was, just look how cheap the stock appeared to be.

The company went through a lengthy restructuring process that we thought made sense and would have a material impact on top-line growth and on profitability. While there was modest improvement, it wasn't happening as fast or with the magnitude we expected. When we asked specific questions of management about metrics we thought were key to assessing the financial performance, they often asked us to just trust them that all was on track. We lost confidence the changes would have the impact expected so decided to exit – at a profit, but a modest one.

Is there a case to be made that your strategy is well suited to what you consider the prospective market environment?

DO: The biggest risks are always the ones you don't foresee. The world overall isn't in a great place. We have a lot of geopolitical conflict. China's population is shrinking, growth is constrained, and they have a massive property bubble they're not in a great position to deal with. Europe is weak, with a shrinking population and an uncompetitive industrial base. Government debt is way too high in the U.S., deficits are structural and there seems to be no political will to deal with the problem. The world has a lot of problems and not a lot of growth, which is a bad combination.

I don't know what's going to happen next so I can't say if our approach will be the best for that or not. What I would say is our approach is thoughtful, rationally based, has been practiced successfully over many years, and tries to combine the right balance between trying to make money and trying desperately not to lose it. It's a reasonable and sober approach. As far as I'm concerned, reasonable and sober is always right for the times. VII

Investment Results as of 9/30/24 (%) Artisan Global Value Fund	QTD	1 year	5 year	10 year	Inception	Expense Ratio
Investor Class: ARTGX	5.79	29.24	10.83	8.32	8.25	1.32%[1]
Advisor Class: APDGX	5.80	29.43	10.99	8.47	8.47	1.17%[1]
MSCI AC World Index	6.61	31.76	12.19	9.39	9.39	
MSCI AC World Value Index	9.42	26.89	9.04	6.65	6.65	

Source: Artisan Partners/MSCI. Class inception: Investor (10 Dec 2007), Advisor (1 April 2015). For the period prior to inception, Advisor Class performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Advisor Class and the share class's returns during that period would be different if such expenses were reflected. [1] Prospectus dated 30 Sep 2023. See prospectus for further details.

Investment Results as of 9/30/24 (%) Artisan Select Equity Fund	QTD	1 year	3 year	Inception	Expense Ratio
Investor Class: ARTNX	6.20	32.32	8.17	12.35	3.18%/1.26%[1]
Advisor Class: ARDNX	6.19	32.47	8.28	12.44	3.67/1.16%[1]
S&P 500® Index	5.89	36.35	11.91	17.51	

Source: Artisan Partners/S&P. Class inception: Investor (28 February 2020), Advisor (28 February 2020). [1] (%Gross/Net). Prospectus dated 30 Sep 2023. Net expenses reflect a contractual expense limitation agreement in effect through 31 Jan 2025. See prospectus for further details.

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Dan O'Keefe is the lead portfolio manager for Artisan Global Value Fund and Artisan Select Equity Fund. Mike McKinnon is a portfolio manager for Artisan Global Value Fund and Artisan Select Equity Fund. This article represents the views of John Heins of Value Investor Insight and Dan O'Keefe and Mike McKinnon as of 31 October 2024 and do not necessarily represent those of Artisan Partners. The views and opinions expressed are based on current market conditions, which will fluctuate, and those views are subject to change without notice. While the information contained herein is believed to be reliable, there is no guarantee to the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Artisan Partners is not affiliated with Value Investor Insight.

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